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FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

## ERRATA

<sup>1</sup> Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, FCC 95-132 (released Apr. 7, 1995) (LEC Price Cap Performance Review).

activity actually chosen." R. Ekelund, Jr.  
and R. Tollison, Economics Fourth Edition 4  
(4th ed. 1994).

4. In paragraph 373, the word "become" is corrected to read "becomes".

5. In the last sentence of paragraph 378, the word "immeditate" is corrected to read "immediate."

6. In paragraph 382, the word "it" was omitted from the last sentence. The last clause of that sentence is corrected to read as follows: "because it would allow LECs to mix non-competitive local switching with potentially competitive tandem switching."

7. Footnote 765 is corrected to read as follows:

Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, CC Docket Nos. 89-79 and 87-313, 6 FCC Rcd 4524, 4524 (1991) (Part 69 ONA Order); modified on recon., 7 FCC Rcd 5235 (1992) (Second Further Reconsideration); further recon. denied, FCC 94-348 (released Dec. 29, 1994) (Third Further Reconsideration).

8. In the last sentence of Appendix E, the phrase "1984/84 data point" is replaced with the phrase "1984/85 data point."

9. In Equation 7 of Appendix F, Attachment B, the term "GNP-PI" is replaced with "GDP-PI."

10. Due to a printing error, some of the language in the bottom right hand corner of page 2 of Commissioner Chong's separate statement was omitted from the First Report and Order. The complete text of Commissioner Chong's separate statement is attached.

FEDERAL COMMUNICATIONS COMMISSION



Kathleen M.H. Wallman  
Chief, Common Carrier Bureau

March 30, 1995

**SEPARATE STATEMENT OF  
COMMISSIONER RACHELLE B. CHONG**

*Re: Price Cap Performance Review for Local Exchange Carriers, First Report and Order,  
CC Docket No. 94-1*

By this First Report and Order, the Commission makes important modifications to its scheme of price cap regulation for local exchange carriers ("LECs"). These changes are made after four years of experience with LEC performance under the Commission's initial price cap regime. The revised interim plan adopted in this decision contains significant improvements that, in my judgment, should more fully serve the public interest goals underlying price caps. I write separately to express my strong support for this item, and to touch on a few of the modifications and their relationship to our goals.

First, a price cap scheme of regulation should ensure rates that are just, reasonable and not unduly discriminatory. In this decision, we further this fundamental goal by reassessing our calculations regarding LEC productivity that served as the basis for setting the initial rates under price caps in 1990. Specifically, we revisit our 1990 decision to include in our calculations access price data for the 1984-1985 tariff year. This specific data emerged from the most tumultuous year in the history of American telecommunications, when AT&T – the largest corporation the world has known – was dramatically restructured. The so-called "1984 data point" varied significantly from data relating to the other years considered in the study. Inclusion of the 1984 data point had a substantial downward impact on the Frentrup-Uretsky study's overall measure of LEC productivity. This study, in turn, resulted in the selection in 1990 of a lower annual productivity offset – or so-called "X-Factor" – for the LECs.

Record evidence submitted in this docket now calls into question the Commission's original judgment in 1990 to include the 1984 data point in its initial productivity calculations. Indeed, this new evidence – aided by the acuity of hindsight – now persuades us that the Commission erred by considering this data back in 1990. We correct this error in this decision for an important policy reason. By correcting our error on a prospective basis, we ensure that future rates are not impacted by what we can now see is an anomalous 1984 data point. This correction involves two changes: (1) an upward adjustment to relevant X-Factors; and (2) a one-time downward adjustment to the LECs' price cap indices. These corrections should more effectively ensure just and reasonable rates for consumers in the future.

Second, to the extent possible, our price cap rules should sever the link between prices and traditional notions of rate-of-return regulation. Some parties have criticized the Commission's initial price cap regime for LECs because it employs two "backstop" mechanisms – the sharing and low-end adjustments – which potentially are triggered by an individual LEC's reported rate-of-return. Under the sharing mechanism, reported earnings that exceed certain thresholds established by our rules must be returned, in whole or in part, to consumers. Conversely, earnings that fall below a certain threshold entitle a LEC to increase rates through the low-end adjustment mechanism. LECs argue strenuously that grafting rate-of-return mechanisms such as these onto our price cap regime blunts the profit incentives that animate a price cap world.

During this proceeding, I have challenged the notion that sharing must continue to play a role in the scheme adopted in this decision. My belief is that sharing can work at cross-purposes to the profit incentives underlying price caps. In this proceeding, I heard from the staff and many parties – including some LECs – that sharing is a necessary, if unwelcome, component of any price cap scheme involving multiple X-Factor options. The evidence supports multiple X-Factor options, given the wide divergence of LEC performance under price caps. Absent sharing on the low or middle X-Factor options, I was told, a LEC would have no incentive to elect a more challenging X-Factor – even if the higher X-Factor was legitimately within the LEC's reach. Over time, I was persuaded by this argument and concluded that it is not feasible at this point to do away with sharing completely. I therefore have come reluctantly to accept the need to retain sharing and the low-end adjustment in the interim plan. I want to be clear, however, about my long-term goal for price cap regulation – my preference is to sound the death knell for sharing, and for other vestiges of rate-of-return regulation.

With this decision, I am pleased that the Commission takes a step – albeit a cautious one – away from the prior plan's reliance on rate-of-return backstops. I recognize that this interim plan, in some respects, contains elements of rate-of-return regulation, primarily sharing, in two of the X-Factor options. I find it significant that in this interim plan the LECs will have the option, for the first time, to elect a higher annual X-Factor that does not contain these rate-of-return mechanisms. I believe this is in the public interest because the prospect of higher earnings should act as an incentive to LECs to select the most challenging X-Factor and to strive to increase efficiency. Meanwhile, consumers will benefit by the resulting reductions in access charges.

Third, our price cap scheme should encourage LEC productivity to the maximum extent possible, while recognizing that individual LECs face different competitive and economic circumstances that affect their ability to achieve a single industry-wide productivity target. To this end, we have modified the current two-option X-Factor approach by adding another X-Factor option between the lowest and highest productivity offsets. The options of the interim plan offer gradations of sharing: fairly strict sharing at the lowest option, more lenient sharing in the middle, and no sharing associated with the

highest X-Factor. Carriers now have additional choices and the incentive to self-select the X-Factor that most closely resembles their ability to achieve productivity gains.

The prospect of being able to retain higher earnings by selecting a more challenging X-Factor offers strong incentives for carriers to move up the X-Factor continuum. Again, the selection of higher X-Factors should offer consumers benefits in the form of lower access charges. Those carriers that cannot meet more challenging X-Factors, due to short run competitive circumstances, regional economic pressures or other reasons, may find it necessary to select the lowest X-Factor. Presumably, carriers in such circumstances will not achieve high earnings and thus will incur little if any sharing obligation. Carriers that believe they can accept the most challenging productivity offset should select the highest X-Factor. And carriers somewhere in the middle of these outer productivity boundaries have yet another option. In short, the plan recognizes that LECs are heterogeneous in terms of productivity, and offers more choices to carriers to reflect that diversity. This approach is consistent with one of my basic regulatory tenets: to craft flexible regulations that are adaptable to differing and changing circumstances.

In addition to adopting an interim plan in this decision, we will soon be issuing a further notice of proposed rulemaking in this docket to consider transitional and long-term issues regarding our LEC price cap regime. I urge that we carefully consider what our regulatory regime should look like at the end of the millennium and into the twenty-first century. We must develop a forward-looking blueprint to guide the transition from price cap regulation to more flexible, streamlined regulation as competition evolves in the provision of interstate access services.

The emergence of competition, and its implications for regulation, should be a central focus of this further proceeding. As competition begins to take hold in a particular geographic or service market, our rules should provide increased flexibility to the LECs to compete fairly for interstate access business. While price cap regulation is designed, to the extent possible, to replicate a competitive marketplace, any form of regulation is an imperfect surrogate for full-fledged competition. Where it can be shown that a particular market is fully competitive, our regulation should give way to competitive market forces to ensure that rates are just, reasonable, and not unduly discriminatory. To achieve this goal, we must develop workable, objective criteria to measure the extent of effective competition. This is a difficult challenge, but one I believe we can meet with the help of the parties. We simply need to get on with it.—